

U-999/CI-92-96 ORDER ADOPTING ACCOUNTING STANDARD AND ALLOWING  
DEFERRED ACCOUNTING

BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

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Chair  
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In the Matter of the Accounting  
and Ratemaking Effects of the  
Statement of Financial  
Accounting Standards No. 106

ISSUE DATE: September 22, 1992

DOCKET NO. U-999/CI-92-96

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**PROCEDURAL HISTORY**

In December, 1990, Statement of Financial Accounting Standards (SFAS) 106 was issued by the Financial Accounting Standards Board (FASB), the body which sets accounting standards for American finance and business. SFAS 106 changed the accounting treatment of other post-employment benefits (OPEBs) for most American companies, including Minnesota regulated utilities. In most cases the change was set to take place for fiscal years beginning after December 15, 1992.

Because this accounting change has great potential impact on utility ratemaking, the Commission issued its ORDER INITIATING INVESTIGATION, GRANTING DISCOVERY RIGHTS, REQUIRING FILING, SOLICITING COMMENTS, AND PROTECTING PRIVILEGED INFORMATION on March 13, 1992. In that Order the Commission initiated an investigation into regulatory issues raised by the new accounting standard. The Commission ordered all Minnesota utilities, including telephone companies, to respond to 14 questions concerning the companies' present and planned accounting treatment of OPEBs. The Order established initial and reply comment periods for parties to the proceeding.

Comments were filed by various energy utilities, telephone companies, a group of northern Minnesota large industrial utility customers known as the Taconites, the Residential Utilities Division of the Office of the Attorney General (RUD-OAG) and the Department of Public Service (the Department).

The matter came before the Commission for consideration on August 12 and August 20, 1992. At the meetings, representatives of Midwest Gas, Northern States Power Company, and Minnesota Power addressed issues affecting energy companies. A representative of the Minnesota Telephone Association spoke

concerning the viewpoint of Minnesota telephone companies. A representative of the Taconites presented oral comments. Comments from the RUD-OAG, the Department and US WEST were also heard.

## **FINDINGS AND CONCLUSIONS**

### **I. Factual Background**

SFAS 106 sets the accounting standard for OPEBs provided by companies to their employees. OPEBs include such non-pension post-employment benefits as medical, dental and life insurance coverage. Prior to SFAS 106, such benefits have been accounted for on a pay-as-you-go basis. After SFAS 106 is implemented, companies will account for these benefits by the accrual method. Expenses will thus no longer be recognized as they are actually paid, but rather will be recognized on an estimated pro-rata basis as employee service is rendered. Although the implementation of SFAS 106 will not change either the total cost of OPEBs or when the companies will actually pay the expenses, it will change the timing of recognition of the cost. This change will increase the annual recognition of Minnesota utility OPEB costs from approximately \$26,000,000 to in excess of \$93,000,000, resulting in a change in revenue requirement of approximately two percent.

The change in accounting methods is at least partially in response to a significant rise in company liabilities for health care benefits. The increased liability is due to rising health care cost, increased utilization of health care benefits by employees, greater life expectancies for retired employees, and higher deductibles for other forms of health coverage such as Medicare. SFAS 106 is meant to provide a better matching of current OPEB expenses with related employee services.

Several issues surrounding SFAS 106 drew special mention from commenting parties. Parties addressed regulatory treatment of the transition obligation, the total accrued benefit obligation as of the first day of the year when a company converts from pay-as-you-go to accrual accounting for SFAS 106. Parties also discussed SFAS 71, which in some cases allows regulated entities to use alternative accounting methods due to the economic effects of the actions of regulators. Parties also commented on the issue of funding the OPEB obligation. Although SFAS 106 does not require funding, parties held differing views regarding the advisability of internal or external funding.

## **II. The Accounting Method for OPEB Costs**

### **Positions of the Parties Regarding the Accounting Method**

The utilities urged the Commission to approve the concept of accrual accounting of OPEBs, both for utility accounting purposes and for ratemaking purposes. The utilities argued that the Commission should adopt the SFAS 106 treatment for ratemaking purposes because it results in more accurate matching between OPEB expenses and services provided, does not result in intergenerational unfairness, brings about rate stabilization, and is consistent with Minnesota ratemaking practice. Because SFAS 106 treatment is mandatory for many utilities for financial reporting purposes after December 15, 1992, the utilities argued that they could not remain on a pay-as-you-go basis for ratemaking purposes without compromising their financial integrity. Financial hardship would occur because neither the Securities Exchange Commission nor the financial community would accept the regulatory asset which would represent the difference between accrual accounting and pay-as-you-go ratemaking recovery.

The utilities argued further that OPEB costs calculated under SFAS 106 are "like in nature and kind" and thus subject to recovery in interim rates under Minn. Stat. § 216B.16, subd. 3. If not recovered in interim rates, deferred accounting should be allowed until the utility's next general rate case.

The Department recommended adopting SFAS 106 treatment prospectively for ratemaking purposes. The Department recommended that the Commission use this docket to establish general policies regarding OPEB accounting, but determine actual utility recovery of OPEB costs on a case by case basis.

The RUD-OAG argued that SFAS 71 allows the Commission the option of requiring continued pay-as-you-go treatment for Minnesota utility ratemaking purposes. Continued pay-as-you-go treatment, with the creation of a regulatory asset, would assure regulatory consistency, expense certainty, and fairness. The RUD-OAG argued that there is no record at this time to support the concept of SFAS 106 accounting for ratemaking purposes. Each utility should be held to its burden of proof to show in a general rate case the necessity of adopting SFAS 106 for ratemaking purposes.

The Taconites argued that there is no proven benefit to ratepayers to justify a change to SFAS 106 accounting for ratemaking purposes. The Taconites argued that the Commission has the ability to establish ratemaking accounting methodology and should not be influenced by changes in FASB accounting methods. The Taconites urged the Commission to hold utilities to the pay-as-you-go accounting method for ratemaking purposes. If the Commission would not order utilities to maintain their pre-SFAS 106 accounting methods, then the Commission should at least examine each utility's adoption of SFAS 106 accounting on an individual rate case basis. Until each utility is examined in a

rate case context, deferred accounting of the increased SFAS 106 cost should be allowed.

#### Other Issues Arising from a Change to SFAS 106 Treatment of OPEBs

##### a. Transition Obligation

The transition obligation represents the amount accrued for OPEB benefits from employee service already rendered, on the first day of a year in which a company moves from pay-as-you-go treatment of OPEBs to the accrual method. Parties differed in their recommendations regarding the treatment of a transition obligation if SFAS 106 were adopted for ratemaking purposes.

The utilities argued that there should be total recovery of any transition obligation because such an obligation represents a cost of providing service. According to the utilities, disallowing recovery would be confiscatory.

The Department argued that recovery of a transition obligation could amount to retroactive ratemaking. If not considered to be retroactive ratemaking, the liability should be shared between ratepayers and shareholders. The Department recommended that the Commission solicit comments on the issues of transition costs and cost sharing between shareholders and ratepayers.

If the Taconites' first recommendation were followed, utilities would remain on a pay-as-you-go basis and no transition obligation would be created. The Taconites argued against recovery of any transition obligation by a utility because such recovery would be asking today's ratepayers to pay for the costs of benefits enjoyed by yesterday's ratepayers.

##### b. Funding

SFAS 106 does not require funding for OPEB obligations. The utilities indicated that they are not presently funding their OPEB accounts. They asked that this issue be decided on a case by case basis, in a manner which would assure the least possible cost. The Department recommended that external funding be required, in order to provide assurance of future payment of these obligations. The RUD-OAG discussed various funding options.

#### Commission Action

The Commission recognizes that significant changes in employee life expectancies, health care costs, and government social programs have had an impact on the treatment of OPEBs by businesses and the financial community. SFAS 106 reporting of OPEBs is a reasonable means of matching the employee benefit costs with utility services from which those costs arose.

The Commission finds that it is reasonable for a utility to present its case for OPEB rate case recovery, including recovery

of any transition obligation, by means of the SFAS 106 accounting method. This method corresponds with the FASB mandate regarding financial reporting. Accrual accounting in ratemaking tracks the rising cost of OPEB obligations. SFAS 106 accounting for both recordkeeping and ratemaking purposes allows the same standards to apply to all aspects of the corporate books. Bringing ratemaking methods in line with recordkeeping methods for OPEB costs allows shareholders, ratepayers, intervenors and regulatory agencies a means of interpreting the fairness and reasonableness of OPEB expenses. Finally, recording OPEB costs as they are earned rather than as they are paid in the future may bring greater accountability to the present utility management making decisions regarding the level of OPEB expenses.

The Commission emphasizes, however, that allowing a utility to present its case for OPEB rate case recovery by means of SFAS 106 accounting is **not** tantamount to allowing recovery of any or all of the expenses. These costs will be subject to the same careful scrutiny of prudence and reasonableness as any other expense item in a general rate case. The Commission does not consider that a change in accounting method for OPEB costs signals any change in the burden of proof for rate case recovery. Minn. Stat. § 216B.16, subd. 4 (1992) states: "The burden of proof to show that the rate change is just and reasonable shall be upon the public utility seeking the change." In order to recover in rates, a utility must show that OPEB costs, like any other utility expenditure, are prudent and reasonable when presented for rate case recovery.

The Commission does not agree with the Department that the recognition of a transition obligation might amount to retroactive ratemaking. Allowing a transition obligation in rates does not violate the prohibition against retroactive ratemaking found at Minn. Stat. § 216B.23, subd 1 (1991): "the commission shall determine and by order fix reasonable rates, tolls, charges, schedules or joint rates to be imposed, observed, and followed in the future..." This prohibition refers to a utility's recovering in current rates past costs incurred or benefits received. Accrual accounting of OPEBs, however, does not mean that the utility is reaching back for past costs. Rather, the utility is matching current OPEB expenses with related employee services. The change is in the method of reporting only, not in the actual cash payment of benefits which arose from employee services. The fact that a transition obligation appears on a company's books at the time of a change to accrual accounting does not change this concept.

While under pay-as-you-go accounting OPEB expenses are recognized at the same time as they are paid out to employees, the employee services from which the benefits arose occurred in the past. This imperfect matching of expense recognition with employee services also occurs if a transition obligation is recognized. Recovery of OPEB costs under pay-as-you-go accounting has never been considered retroactive ratemaking, and neither should the recovery of a transition obligation which arises as a result of a

change to accrual accounting. Neither of these situations is the type of reaching back for past costs which the retroactive ratemaking doctrine prohibits. The utility is not in either case attempting to recover in current rates costs which should properly have been recovered in past rates.

For these reasons, recovery in rates of a transition obligation arising from a prospective change to accrual accounting does not result in retroactive ratemaking. The Commission is thus not prohibited by the doctrine of retroactive ratemaking from considering the option of rate recovery of a transition obligation.

The Commission will therefore adopt SFAS 106 accrual accounting for Minnesota utility accounting and ratemaking purposes, subject to Commission review for prudence and reasonableness of the benefit programs and all calculations in future rate cases. The treatment of the transition obligation, including the proper amortization period assigned, and the propriety of funding the OPEB obligation will be decided in each rate case, on a case by case basis.

#### **IV. Implementation of SFAS 106**

As discussed previously, the change from pay-as-you-go accounting to the accrual method for OPEBs may raise utility revenue requirements. If utilities were required to recognize the difference in cost at once, the accounting change could force many utilities to file general rate cases in order to adjust their revenue requirements. The Commission will therefore allow utilities to defer the increased cost created by the change to SFAS 106 accounting. The Commission will limit the time for such deferred accounting for each utility to a period of three years beginning January 1, 1993, or until the issue date of the Order which sets final rates following a general rate case, whichever occurs first. This should allow the utilities sufficient flexibility, while limiting the time during which deferred accounting takes place without Commission review.

The Commission emphasizes that allowing deferred accounting of increased costs due to SFAS 106 accounting does **not** signal any guarantee of recovery of such costs during rate case review. As discussed previously, the level, reasonableness and prudence of OPEB expenses will be examined carefully by the Commission. Only if a utility meets its burden of proof in a general rate case will recovery be allowed.

The Commission will not allow recovery of the increased SFAS 106 costs in interim rates during this period of deferred accounting. Because of the significant change in accounting methodology, these costs are not the same in nature and kind as those allowed in prior rate case proceedings. The costs will thus not be allowed in interim rates under Minn. Stat. § 216B.16, subd. 3.

Finally, the Commission wishes to clarify the application of this Order to certain circumstances. This Order will not change the terms of the incentive plan approved for US WEST Communications, Inc. (US WEST).<sup>1</sup> Neither will the Order alter the terms of Contel of Minnesota's stipulated rate reduction<sup>2</sup>, in which Contel calculated costs for OPEBs in a manner similar to the SFAS 106 method. Whether through an incentive plan proceeding for US WEST or a general rate case for another utility, each utility must prove its case before the Commission for recovery of any increased costs due to changes in accounting.

### ORDER

1. The Commission adopts SFAS 106 accrual accounting for Minnesota utility recordkeeping and ratemaking purposes, subject to Commission review for prudence and reasonableness of the OPEB programs, expenses, and all calculations in future rate cases.
2. The Commission authorizes Minnesota utilities to establish deferred accounting for the increased cost resulting from a change to SFAS 106 accounting, with the deferred balance subject to Commission general rate case review. Deferred accounting will be allowed for each utility for three years beginning January 1, 1993, or until the issue date of the Order setting final rates following a general rate case, whichever occurs first. Interim rate recovery will not be allowed during the deferred accounting period.
3. This Order shall become effective immediately.

BY ORDER OF THE COMMISSION

Richard R. Lancaster  
Executive Secretary

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<sup>1</sup> In the Matter of Northwestern Bell Telephone Company's, d/b/a US WEST Communications, Proposed Incentive Regulation Plan, Docket No. P-421/EI-89-860, FINDINGS OF FACT, CONCLUSIONS OF LAW, AND ORDER, June 7, 1990.

<sup>2</sup> In the Matter of a Joint Petition by the Department of Public Service and the Office of the Attorney General for a Commission Investigation of the Level of Rates Charged by Contel of Minnesota, Inc., Docket No. P-407/C-90-906, ORDER ACCEPTING OFFER OF SETTLEMENT AND STIPULATION, February 13, 1991.